Christian Noyer: The G20 and the role of emerging markets in the new financial architecture

Opening speech by Mr Christian Noyer, Governor of the Bank of France, of the Session "The G20 and the role of emerging markets in the new financial architecture", at the Money and banking conference 2009, Central Bank of Argentina, Buenos Aires, 31 August-1 September 2009.

* * *

I am delighted to introduce this final session devoted to the lessons learned from the crisis regarding the international financial architecture and the role of emerging markets in this new configuration.

The strong and rapid transmission of the crisis from the United States to other industrialised countries, and subsequently to emerging countries, has clearly highlighted the contrast between:

- on the one hand, the heightened exposure of the international economic and financial system to the risk of systemic crisis, due to the increased interdependence between players of developed and emerging economies and financial systems.
- and, on the other hand, our crisis prevention and management instruments, which have proved to be largely inappropriate or insufficient.

Therefore, in order to prevent a similar crisis from occurring in the future, these instruments must be strengthened. This entails a reform of the international financial architecture. The mechanisms and content of international cooperation must be reviewed with the aim of devising crisis prevention and management tools that better take account of the greater interdependencies between the economic and financial systems of advanced and emerging countries.

Against this backdrop, the strong political impetus given by the Heads of State and Government of the G20, at its summit in London on 2 April, is most welcome. Indeed, it is fair that the road map for reforming the international financial architecture was set out by a group that ensures equal representation between industrialised and emerging countries. Work on implementing this road map is now underway and I would like to comment on the progress being made in three areas that I believe essential for achieving the defined goal:

- strengthening financial regulation in a multilateral framework,
- developing multilateral surveillance,
- and enhancing the legitimacy and resources of the institutions that are at the heart of the international financial architecture.

1. Strengthening financial regulation in a multilateral framework

Before discussing the work being carried out in the area of regulation, I would like to highlight some recent welcome developments in terms of the governance of international standard setters.

Indeed, following the decision taken at the London summit to broaden the membership of the Financial Stability Forum (FSF) – re-established as the Financial Stability Board (FSB) – to include all G20 members, Spain and the European Commission, and to enhance its mandate to promote financial stability notably by developing its collaboration with international standard setters, membership of the latter was also recently expanded to increase the representation of emerging countries.

The Technical Committee of the International Organisation of Securities Commissions (IOSCO), charged with regulating the securities markets, broadened its membership to include Brazil, China and India, while the BIS Committee on Payment and Settlement Systems and the Basel Committee on Banking Supervision (BCBS) extended their memberships to encompass 9 and 14 new countries respectively, the majority of which are emerging economies.

Nevertheless, there is a need now to ensure that a good balance is struck between the legitimate enlargement of these bodies to reflect our economic reality and the effective and efficient mechanisms those organisations have shown so far. For example, the Basel Committee must now find ways of adapting in order to function as a 27-member body, compared with a 13-member body beforehand.

I would now like to turn to the work in progress in the areas of prudential regulation, accounting standards and the scope of regulation.

As far as prudential regulation is concerned, the primary imperative is to improve the quality of capital and to harmonise its definition. And this move should go hand in hand with the quick and full geographical extension of Basel II because this framework is designed precisely to ensure that requirements are proportionate to risks and indeed it would certainly have helped if it had been implemented as initially planned before 2008. Beyond that, should we add a simple measure to our arsenal that enables us to assess leverage with a view to helping anticipate the formation of asset price bubbles? I am rather doubtful myself, for several reasons. First, in the absence of single accounting standards, a comparison between banks belonging to different accounting universes will mean absolutely nothing. Second, that sort of ratio did exist in the United States and proved of no help, precisely in the country where the crisis emerged. Finally, in the present circumstances, it could add to the reluctance of banks to be active lenders in the interbank money market, therefore reducing market liquidity and still increasing the over-reliance of the banking sector on the central bank counterparty.

That said, it is essential to enhance the counter-cyclical nature of capital requirements. For instance, implementing a forward-looking provisioning system and an additional capital requirement at the cycle peak would be effective measures to make capital requirements more contra-cyclical. In this regard and especially in the light of the profits announced by the major banking groups and the large payouts to traders, CEOs or shareholders in the form of dividends, I would like to stress that these profits should primarily be used to bolster capital ratios and allow banks to focus on their core task of financing the economy.

All in all, I praise international standards in the field of prudential rules. The ones already developed over many years and which the crisis is now leading us to adapt, or the new ones under scrutiny, are only meaningful and will only produce their desired effects if they are applied by all countries and, needless to say, first of all by those that negotiated them. From that viewpoint, the adoption of the Basel II framework by the United States looks to be one of the most important and urgent issues.

It is also very important to improve and harmonise accounting standards. The views of G20 countries sometimes differ as to the role of accounting. For instance, one contentious issue is marking-to-market and the extent to which fair value accounting should be applied. It is vital that the accounting choices of standard setters better take on board the financial stability dimension, since they have an impact on the latter.

Lastly, the crisis has also highlighted the limitations of self-regulation; it is also essential that the regulation of all systemically important institutions and markets be proportional to their potential impact on financial stability. However, in order to implement such an approach, agreement would have to be reached at the international level on a standard definition of the systemic nature of an entity, which clearly does not depend on its size alone. Moreover, the consistency and the appropriate balance of such potential specific rules with the general rules must also be ensured. For instance, for banks, it is important to allow for the fact that

the size of an institution is already taken into account in the prudential ratios, since capital requirements are proportionate to exposures. It is also important to bear in mind that the diversification of business lines, which goes hand in hand with a certain size of institution, may be a factor of resilience that should not be discouraged. This is an important and delicate task that has been entrusted to the FSB.

2. Developing multilateral surveillance

I will now turn to collective surveillance. Let me start with the following simple observation: the crisis did not emerge from where we were expecting. Our warning systems, both at the national and regional levels, let us down. Above all, we did not have an overall, across-the-board view of the vulnerabilities. We omitted to take into account the interactions between global economic imbalances, international financial stability and national regulation and supervision.

The crisis took us by surprise because it broke out at the heart of the system, i.e. in the US financial sector. Unlike other recent financial crises and in particular the Asian crisis at the end of the 1990s, contagion spread from the industrialised countries to the rest of the world. Surveillance instruments, in particular those of the IMF, were chiefly designed to detect a balance of payments crisis, whereas this crisis first affected the financial systems. We were prepared for a foreign exchange crisis, i.e. a sovereign solvency or liquidity crisis, but we were hit by a liquidity and solvency crisis in advanced countries' financial institutions.

Therefore, one lesson from the crisis is that surveillance must be strengthened across the board, including macroeconomic, financial and regulatory areas. It must be both macro- and microeconomic, incorporating systemic risk in particular.

In Europe, this issue is going to be addressed by a dedicated committee now named the European Systemic Risk Committee that will operate in close collaboration with the European System of Central Banks.

At the global level, the IMF and the FSB have been invited to step up their cooperation to develop early warning exercises. However, the surveillance tools that international institutions have at their disposal or could develop cannot claim to provide exhaustive analysis. Drawing from their own specific expertise, it is therefore important for these institutions to compare their analyses with each other and with other multilateral institutions and national authorities in order to correctly identify all the sources of vulnerability and significant risks of contagion.

This work on multilateral surveillance should also act as a safeguard against temptations, which would be extremely detrimental: just when supervision needs to become more international to deal with interdependent risks, we must avoid national myopia through domestic regulation. This is clearly the case in the area of liquidity. What could also be helpful in this respect is the enhancement of the surveillance of financial systems of all countries in the framework of the Financial System Assessment Program (FSAP), as well as the publication of their conclusions.

3. The last area of reform that strikes me as particularly important is enhancing the legitimacy and resources of the financial institutions at the heart of the international financial architecture

For international cooperation to function, institutions must be efficient and accepted by all economic players. This means that they must have clear mandates, appropriate resources and governance that correctly reflects today's multipolar and interdependent economic and financial world.

In this area, the G20 also agreed on robust measures aiming in particular to adapt the resources and functioning of the Bretton Woods institutions. For instance, while we have observed an increasing number of bilateral initiatives, such as swaps offered by major currency issuers, such as the Fed and Eurosystem, as well as, in a very different context, by China, these mechanisms cannot alone constitute a coherent insurance system. This is why the G20 decided to triple IMF resources to USD 750 billion, which is unprecedented. The intervention tools were also reformed. A multilateral instrument for the prevention and early management of crises was also created, the Flexible Credit Line (FCL); Mexico, Poland and Argentina have already signed up and this has without doubt reduced the risk of contagion. In addition, the Poverty Reduction and Growth Fund was established for the poorest countries. This clearly reflects the IMF's commitment to reforming its assistance and solidarity framework to help the most vulnerable countries. Similarly, the adequacy of the resources of multilateral development banks was reviewed and, for example, the capital of the Asian Development Bank was tripled.

In order to enhance the legitimacy and efficiency of key players in the international financial architecture, the bolstering of resources must go hand in hand with a reform of their governance. As a European, I am perhaps not the best person to give my views on the governance of financial institutions, and of the IMF in particular because, for emerging countries to be given a fair representation, it is most often the representation of European countries that is called into question. You may therefore be tempted to interpret my suggestions negatively. I would, however, first like to say that the representation of European countries should not be contested: Europe is a diverse continent that encompasses small, new, and even emerging countries alongside large and established developed nations. Overall, it is somewhat under-represented in a community that is still made up of sovereign states. And, above all, it seems to me that this is the wrong question or solution given our current challenges: while the issue at stake here is improving dialogue with a view to achieving concerted and operationally-applicable solutions, I do not believe that anyone really asserts that the optimal way to enhance the future of our financial cooperation is to alter the composition of the 24- or 25-strong IMF Executive Board by 3 or 4 members.

Nevertheless, I consider that a number of principles should guide this desired reform: governance today should be adapted to a multipolar financial world. While all members should be represented in proportion to their involvement and responsibilities, more than the complex calculations of quotas and voting rules, we should fundamentally focus on the functioning and mandate of the IMF. In this respect, senior officials should be appointed strictly on the basis of their expertise and the IMF's mandate should be expanded. Focusing on exchange rate developments alone is no longer sufficient, and if the IMF is to be able to contribute to ensuring international financial stability, it must pay greater attention to capital account developments. Furthermore, this contribution cannot simply be a matter of complying with a rigid and uniform body of rules. It must take account, in a balanced manner, not only of each country's level of development but also the systemic risk that it constitutes within the global financial system.

By the same token, for member countries, this requires effective participation in multilateral bodies aiming to foster the development of the international financial system, either through capital account liberalisation or provision of liquidity where necessary, as the crisis has clearly shown. Neither can we escape from the fact that the international status of certain countries' currencies affords them a specific role or may affect them adversely.

In all of these matters, beyond the stereotypical vision of the different interests of developed and emerging countries, I wish to recall that in fact we have converging interests: since we are closely linked in terms of finance and trade, it is in our collective interest to participate in the surveillance of financial systems within an enhanced multilateral framework.

To conclude, I would like to reiterate that the new financial architecture that we are in the process of defining should not be hidebound but gradually adapted to address the major

developments in the international economic and monetary system. In this regard, the possible emergence of a "multicurrency" international monetary system deserves particular attention. Naturally, the US dollar remains the world's foremost reserve currency. Similarly, the euro plays a major role. However, the increasing prominence of other currencies, provided of course that they become fully convertible and tradable without any restriction, suggests that a new situation may materialise in which a growing number of currencies could enjoy international currency status. The possibility of using widely a supranational currency, such as the SDR, has also been proposed and is firmly supported by several emerging countries (although the SDR lacks in fact most of the properties of a true currency). If such a "multi-currency" world did emerge, bearing in mind that international currency status cannot be dictated but is the result of market forces, we would then have to adapt the international financial architecture accordingly.